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Decision 04-03-041 March 16, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Evaluate Existing Practices and Policies for Processing Offset Rate Increases and Balancing Accounts in the Water Industry To Decide Whether New Processes Are Needed	Rulemaking 01-12-009 (Filed December 11, 2001)

ORDER MODIFYING DECISION 03-06-072 AND DENYING REHEARING OF DECISION, AS MODIFIED

In this decision, we dispose of rehearing applications concerning our Decision (D.) 03-06-072. We modify D.03-06-072, as discussed in this decision. Rehearing of D.03-06-072, as modified, shall be denied.

I. SUMMARY

On June 19, 2003, we issued D.03-06-072, our original decision in this case, revising the procedures that Class A water utilities must follow in order to recover offset expenses from balancing accounts existing on or after November 29, 2001. On July 23, 2003, both California Water Association and its Class A Water Utility Members (CWA) and Southern California Water Company (SCWC) filed applications for rehearing. We have carefully reviewed rehearing applicants' contentions and, as discussed below, have concluded that D.03-06-072 should be modified in certain respects and rehearing of the modified decision should be denied.

II. BACKGROUND

In the summer of 2001, several water utilities filed advice letters seeking offset rate increases to compensate for recent increases in the costs of purchased power

that were not anticipated in the utilities' last general rate case (GRC). The Office of Ratepayer Advocates (ORA) protested the request to raise the rates of 20 districts of California Water Service Company (CWS), arguing that: (1) the Commission should not authorize offset rate increases for CWS districts because the utility was "over earning," that is, it was earning a rate of return greater than that authorized in the utility's last GRC; and (2) the Commission should not permit water districts that are outside their rate case cycle to utilize balancing account treatment.[1] (D.03-06-072, pp. 3-4.)

In response, the Commission's Water Division drafted Resolution W-4294 (Reso. W-4294), dated November 29, 2001, which researches the history, rationale, and procedures for implementing offset rate relief and related balancing accounts. The Water Division staff concluded that: (1) ORA's protest raises serious issues of first impression warranting full Commission consideration; and (2) the Commission should consider ORA's recommendations on an industry-wide basis. We agreed with staff's recommendations and issued an Order Instituting Rulemaking (OIR). (D.03-06-072, p. 4.)

In the OIR, we evaluated existing practices and policies for processing offset rate increases and balancing accounts for water utilities and determined that new procedures or policies were needed. Respondents to written inquiries in the OIR included the Class A water and sewer system utilities and ORA. In our interim decision, Decision (D.) 02-12-055, we retained the existing balancing account procedures for processing accounts existing prior to November 29, 2001, but reserved the issue of whether the rules should change prospectively (i.e., on or after November 29, 2001) for the final decision. (D.03-06-072, pp. 4-5.)

After completing the OIR, we issued our final decision, D.03-06-072, on June 19, 2003, revising the existing procedures for recovery of balancing accounts existing on or after November 29, 2001. In D.03-06-072, we found that a revision to the

[1] According to ORA, districts that failed to apply for a GRC when they had an opportunity to do so, either according to the Rate Case Plan adopted in Decision (D.) 90-08-045, 37 CPUC2d 175, or by other Commission decision, would be outside of their rate case cycle.

existing procedures was necessary in order to effectively correct distorted results. We reasoned that the existing procedures for recovery of under and over collections in balancing accounts, which the Commission suspended as of November 29, 2001, were originally established for the utilities to recover unanticipated increases in electricity costs[2] between GRCs, without the need to file an additional rate case application. The procedures also served the purpose of protecting shareholders from having to finance large unanticipated expenses until the next GRC. These procedures served, in effect, as insurance to protect a utility against its failure to earn its authorized rate of return due to significant unforeseen expenses beyond the utility's control. Thus, we found that offset balancing account recovery should only occur when the utility fails to earn up to its authorized rate of return due to significant unforeseen expenses beyond its control that are the subject of the balancing account. To the extent a utility is over earning, such over earnings shall be used as a measure by which recovery of offset expenses from the balancing account should be reduced since the event insured against (i.e., the failure to earn its authorized rate of return) has not occurred. (D.03-06-072, pp. 14-15.)

We found that the balancing account procedures became problematic when they had the effect of enhancing utilities' earnings above the Commission-authorized rates of return. The Commission found that it is unreasonable and unnecessary to permit the utilities to pass through to ratepayers the dollar-for-dollar costs accumulated in their balancing accounts when these same utilities are earning more than their authorized rate of return. To permit such recovery would be to grant the utilities an unanticipated windfall at ratepayer expense. (D.03-06-072, p. 15.)

Moreover, we found another related problem with the existing balancing account procedures occurred when a utility failed to file a GRC application every three years, yet continued to seek balancing account treatment beyond the rate case cycle, thus depriving us of scrutiny over the assumptions used to determine the rate structure. Because general ratemaking is conducted prospectively, the utility's revenue requirement

[2] The Commission expanded this balancing account mechanism to include two additional types of unanticipated expenses: pump taxes and water acquisition expenses.

relies upon estimates of costs and capital investment expected to occur in the future years for which rates are being set. "Adopted sales quantities" are used in this estimation. The 1983 revised balancing account procedures addressed the use of GRC adopted quantities. Adopted quantities are used to estimate the reasonable cost pass-through to be allowed in offset rate increases when a utility experiences new costs in offsettable expenses. "Stale adopted quantities" refers to adopted sales quantities that are part of an aged GRC, and are unreliable because they do not accurately reflect or predict the relevant changes in a utility district's conditions since the last GRC. Use of such quantities with the pro-forma test could render the pro-forma test an unreliable measure of a utility district's earnings and provide utilities with undeserved income. (Reso. W-4294, p. 10.) While we anticipate that this problem will be addressed by subdivision (c) of Section 455.2, requiring water utilities subject to the rate case plan to file rate cases every three years, that section permits the three-year filing requirement to be waived, as specified. (D.03-06-072, p. 16.)

III. DISCUSSION

A. D. 03-06-072's Revision Of Procedures For Recovery of Balancing Accounts Existing On Or After November 29, 2001, Is Not Unlawful Or Unconstitutional

Both California Water Association (CWA) and Southern California Water Company (SCWC) assert that the revised procedures for recovery of balancing accounts set forth in D.03-06-072 are unlawful and unconstitutional. (CWA Rhg. App., p. 5; SCWC Rhg. App., p. 1.) CWA points out that although public utilities are not guaranteed the right to earn their authorized rates of return, it is a basic tenet of public utility law that they must be afforded the opportunity to earn a fair rate of return (citing *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia (1923)* 262 U.S. 679, 692-693). CWA argues that by prohibiting a water utility from recovering accrued offset costs in a balancing account, which were reasonably and prudently incurred in the provision of public utility service in any year in which the water utility happens to be earning above its authorized rate of return, the Commission is denying that utility – over

a period of time – the opportunity to earn its authorized rate of return. (CWA Rhg. App., p. 7).

We disagree. A correct interpretation of the revised balancing account procedures reveals the following:

(1) If a utility is either within or outside of its rate case cycle and is not over earning, the utility shall recover from the balancing account subject to reasonableness review.

(2) If a utility is either within or outside of its rate case cycle and is over earning, the over earnings will be used as a measure by which recovery of offset expenses in the balancing account will be reduced. For example, if the amount of the over earning is equal to or exceeds the amount of offset expenses to be recovered in the balancing account, those expenses shall be reduced to zero. Any offset expenses accumulated in the balancing account would be amortized below the line and any offset revenues collected in the balancing account would be returned to ratepayers.

(3) If a utility is within or outside of its rate case cycle and is over earning, but the over earnings are not equal to or greater than the offset expenses accumulated in the balancing account, the offset expenses in the balancing account will be reduced by the amount of the over earnings. If there are offset revenues in the balancing account, then these shall also be used to reduce the remaining offset expenses accumulated in the balancing account to zero. After the offset expenses in the balancing account are reduced to zero, if any offset revenues remain in the balancing account, such revenues shall be returned to ratepayers. If, conversely, after adjusting offset expenses in the balancing account by the amount of over earnings and offset revenues, offset expenses still remain in the balancing account, such expenses shall be amortized and recovered through a surcharge request in an Advice Letter or a GRC.

In light of these principles, CWA's arguments lack merit. The revised procedures set forth in D.03-06-072 neither disallow a water utility from recovering costs prudently and reasonably incurred in the provision of public utility service, nor deny a water utility the opportunity to earn its authorized rate of return over time. In fact, no matter how much a company has over earned, the over earnings are never used to reduce offset expenses below zero. In reality, the utility retains all of its over earnings. As the summation of the revised procedures set forth above indicates, such procedures simply require a utility to use over earnings as a measure by which the utility reduces offset expenses before being able to recover such expenses from the balancing account.

Both CWA and SCWC are well aware that the purpose of providing this rate adjustment mechanism is to protect utilities from unforeseen expenses of a significant nature over which the utility has no control. This purpose is stated in Reso. W-4294. In the situation where a utility is over earning, it clearly does not need this type of protection. D.03-06-072 finds that it is unreasonable and unnecessary to permit the utilities to pass through to ratepayers the dollar for dollar costs accumulated in their balancing accounts when these same utilities are earning more than their authorized rate of return. As the decision points out, to permit such recovery would be to grant the utilities an unanticipated windfall at ratepayer expense. (D.03-06-072, p. 15.) Conversely, if a utility is under earning, the utility may recover all of its offset expenses subject to reasonableness review. Thus, we find our rationale for revising the balancing account procedures to reasonably protect both shareholder and ratepayer interests.

We agree that the description of the revised procedures throughout the decision needs clarification. Therefore, we modify these parts of the decision to clarify the revised procedures as set forth below.

1. The Implementation Of The Revised Balancing Account Procedures Does Not Constitute Retroactive Ratemaking

CWA asserts that the decision's disallowance of costs reasonably and prudently incurred in the provision of public utility service when a water utility is over earning constitutes unlawful retroactive ratemaking as prohibited by and articulated in *Pacific Telephone & Telegraph Co. v. Public Utilities Com. (1965)* 62 Cal. 2d 634 *(PacTel).* (CWA Rhg. App., p. 9.) As a threshold matter, as explained above, we reject CWA's argument that the revised balancing account procedures result in disallowing reasonably incurred costs. We also disagree with CWA that the revised balancing account procedures constitute unlawful retroactive ratemaking.

In PacTel, supra, the California Supreme Court overturned a portion of a rate order on the grounds that it constituted impermissible retroactive ratemaking because if affected general rates. (Id. at 650.) In *Southern California Edison Co. v. Public Utilities Commission (1978)* 20 Cal.3d 813 (*SoCal Edison)* 20 Cal. 3d 813, the California Supreme Court distinguished between general ratemaking and rate adjustment mechanisms. In *SoCal Edison*, we replaced Edison's fuel clause, under which Edison had over collected tens of millions of dollars, with an "Energy Cost Adjustment Clause" (ECAC). Under the ECAC, Edison was required to record its actual fuel costs in a balancing account. Since both "over" and "under" collections in the balancing account are regularly amortized, we eliminated the possibility that Edison in the future would have such a large, long-term over collection as it had obtained under the fuel clause. We also ordered Edison to return to its ratepayers over a three year period the over collection generated under the prior fuel clause. Edison challenged this refund order as impermissible retroactive ratemaking.

The court rejected Edison's argument and distinguished between general ratemaking cases, in which many variables are taken into account and broad policies are formulated, and cases involving the narrowly restricted and semi-automatic functioning of an adjustment clause. The court found that we were correct in finding that the rates

fixed by operation of the fuel cost adjustment clause were not "general rates" but "extraordinary rates not created by or in a general rate proceeding" and that "[t]he future reduction of fuel clause adjustment rates is not retroactive ratemaking," even though designed "to reflect past over or under collections." (Id. at 829-30 & fn. 21.) The court noted that the fuel clause was intended only to reimburse Edison for its increased fuel costs and not to contain any element of profit. This fact further supported the court's conclusion that Edison could be required to return the windfall of its past over collections to its ratepayers. (Id. at 818, 830-31.)

Although CWA acknowledges the holding in *SoCal Edison*, supra, CWA asserts that D.03-06-072 goes beyond the adjustment of rates by operation of the balancing accounts and "indirectly – though clearly – impacts general rates on a retroactive basis therefore representing unlawful retroactive ratemaking." (CWA Rhg. App., p. 9.) Specifically, CWA asserts that "a utility is denied the recovery of reasonably and prudently incurred costs accrued in a balancing account to the extent that it is over earning on its authorized rate of return, even though such over earning results from rates established in its prior general rate case. Thus, this procedure has the effect of adjusting past Commission-authorized general rates (through a current refund and below-the-line write-off of recoverable costs) based on a hindsight review of a utility's earnings. Such a result constitutes unlawful retroactive ratemaking." (CWA Rhg. App., pp. 9-10.)

CWA's argument is incorrect. The revised procedures for recovery of offset expenses from balancing accounts do not adjust general rates authorized by this Commission in the past based on a hindsight review of a utility's earnings. CWA is well aware of the fact that this rate adjustment mechanism is not part of a general ratemaking proceeding[3], and has no direct or indirect effect on general rates. The revised balancing account procedures simply require the utility to use the over earnings as a measure by

[3] When the Commission first established rules for expense offsets for water utilities in 1977, the 1977 policy described the advice letter offset program for purchased power, water, and pump taxes as similar to the ECAC the Commission established in the *SoCal Edison* case, allowing water utilities to recover cost increases generally beyond the utilities' immediate control. (See Memorandum to the Commission from B.A. Davis, Director, Operation Division, Subject: Major Water Utilities Regulatory Policy. Approved at the Commission Conference, June 28, 1977.)

which it reduces offset expenses before being able to recover such expenses from the balancing account. Therefore, if the utility is over earning and such over earnings equal or exceed the amount of offset expenses in the balancing account, then the utility would not recover the offset expenses from offset revenues in the balancing account. Since the purpose of the balancing account is to protect utilities from unforeseen significant expenses that would adversely affect its rate of return, a utility that is over earning does not need the protection offered by this rate adjustment mechanism.

D.03-06-072 provides that "offset balancing account recovery should only occur when the utility fails to earn up to its authorized rate of return due to unanticipated expenses beyond its control and that are the subject of the balancing account." (D.03-06-072, p. 15.) SCWC asserts that the court in *SoCal Edison*, supra, rejected the notion that recovery of the fuel clause was in any way related to a utility's return on rate base (SCWC Rhg. App., p. 3.), and asserts that "there should be no link between the operation of the balancing account, on the one hand, and whether the utility earns its authorized rate of return, on the other hand." (Id. at 4.)

SCWC ignores the fact that the court in *SoCal Edison*, supra, noted that the fuel clause was intended only to reimburse Edison for its increased fuel costs and not to contain any element of profit. (Id., at 818, 830-831.) The court stated "no portion of such a rate increase may lawfully represent a profit to the utility." (Id. at 818-819.) The revised procedures address this very issue. Prior to D.03-06-072, recovery from the balancing account could result in a profit to the utility when the utility is over earning. To remedy this potential windfall, the revised procedures simply require a water utility, if over earning, to use its over earnings as a measure by which to reduce offset expenses because, in reality, the utility's rates generated enough revenue to pay for the increased expenses without the use of this rate adjustment mechanism. Therefore, we find that the revised procedures are consistent with the court's reasoning in *SoCal Edison*, supra, and do not result in retroactive ratemaking.

2. The Revised Procedures For Recovery Of Balancing Accounts Do Not Violate Due Process Guaranteed by the Constitution of the United States or California.

Both CWA and SCWC allege that the decision violates both substantive and procedural due process guaranteed by the U.S. and California Constitutions. (CWA Rhg. App., pp. 10, 13; SCWC Rhg. App., p. 6.) These arguments obfuscate their real complaint: that the Commission, after providing notice and the opportunity to be heard to affected parties, revised its procedures to correct an inequity to ratepayers. In any event, the revised procedures do not deny either substantive or procedural due process.

a) Substantive Due Process

The United States Supreme Court has interpreted the due process clause of the Fourteenth Amendment as providing two distinct guarantees: substantive due process and procedural due process. (*Zinermon v. Burch (1990)* 494 U.S. 113, 125.) CWA alleges that D.03-06-072 is arbitrary and capricious, therefore violating substantive due process, because there is no evidence upon which it bases its conclusion that balancing account procedures and cost offsets enhance a utility's earnings above the Commission's authorized rates of return. (CWA Rhg. App., p.13) SCWC alleges that the decision violates substantive due process by not setting forth evidence upon which it bases its conclusion that the existing procedures for maintaining balancing accounts produce "distorted results." (SCWC Rhg. App., p. 6.)

Substantive due process protects against "certain arbitrary, wrongful government actions" (Id. quoting from *Daniels v. Williams (1986)* 474 U.S. 327, 331.) "A substantive due process challenge to an economic regulation must satisfy a two-part test: (1) does the ordinance must serve a legitimate purpose, and (2) are the means employed rationally related to the legitimate purpose? (Citations omitted). The Ninth Circuit has articulated the test as one that requires that the plaintiff "prove that the government's action was clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare." [Citations omitted.] (*Adamson Companies v. City of Malibu (1994)* 854 F. Supp. 1476, 1485.)

Applicants' objections are inaccurate and without merit. In a rulemaking to adopt policies and procedures, we are not required to rely on specific evidence in reaching our legal conclusions and findings. Because of the quasi-legislative nature of such proceedings, we are free to rely on a variety of materials in lieu of evidence to reach our legal conclusions and findings. Rule 14.1of the Commission's Rules of Practice and Procedure makes this clear: "Rulemaking is a formal Commission proceeding in which written proposals, comments, or exceptions are used instead of evidentiary hearings." Therefore, the assertion that we must rely on evidence in reaching our conclusions in a rulemaking is inaccurate and contrary to the rules defining this type of proceeding.

Nevertheless, there is ample evidence in the record of this proceeding upon which the Commission based its conclusion that the existing procedures become problematic when they have the effect of enhancing a utility's earnings above its authorized rate of return. (D.03-06-072, p. 15.) It is this record evidence (along with other materials, including matters presented in oral argument and in an all-party ex parte meeting with Commissioner Brown) that supports the conclusion at issue. Clearly, if these utilities are already over earning, then recovery of cost offsets from the balancing account will only enhance those over earnings, which have already provided the utilities with a revenue stream from which to recover offset expenses. In any case, the notion that D.03-06-072 violates substantive due process due to lack of evidence is erroneous and lacks merit.

CWA also states "there is no rational relation between the denial of recovery of under collections in water utility balancing accounts and the "valid state objective" in preventing a utility from over earning in any given year." In fact, CWA disputes that the prevention of over earning is a valid state objective at all. (CWA Rhg. App., p. 13.)

This objection is not only inaccurate, but also misleading. The decision does not deny recovery of under collections in a utility's balancing account. If a utility is not over earning, it is entitled to recover its offset expenses from the balancing account subject to reasonableness review. The revised procedures simply require a utility that is

over earning to use such over earnings as a measure by which to reduce offset expenses prior to recovery from the balancing account. This does not constitute disallowance of those costs. The utility has, in fact, recovered those costs as a result of its over earning. We do not think that the utility should recover those same costs again from the balancing account. Moreover, the valid state objective we are pursuing by revising the procedures for recovery of balancing accounts is the protection of ratepayers – not the prevention of over earning by utilities. Our goal is to protect ratepayers from unnecessary rate increases, obtained through the use of an offset rate increase and balancing account, when a utility is over earning and does not need the protection offered by this rate adjustment mechanism. The means employed to protect ratepayers in this regard are the revised procedures for recovery of balancing accounts. Clearly, such revised procedures are rationally related to the legitimate purpose of protecting ratepayers. Hence, both CWA and SCWC have failed to meet their burden of proving that D.03-06-072 is in any way arbitrary, capricious, or unreasonable.

Both CWA and SCWC allege that we violated procedural due process by issuing D.03-06-072 without holding evidentiary hearings regarding whether the revised procedures deprive utilities of their property, that is the offset expenses accumulated in the balancing account. (CWA Rhg. App., pp. 13-14; SCWC Rhg. App., pp. 7-8.) CWA specifically asserted that issues of possible increased risk from the OIR's proposed changes, and how various risks affect a utility's rate of return, should be considered in evidentiary hearings.

Procedural due process requires that a person in jeopardy of being deprived of liberty or property be given notice of the pending action that could result in such a deprivation and "the opportunity to be heard at a meaningful time and in a meaningful manner." (*Mathews v. Eldridge (1976)* 424 U.S. 319, 333; internal quotation marks omitted).

As noted above, Rule 14.1, supra, does not require us to have an evidentiary hearing in a quasi-legislative proceeding. D.03-06-072 results from Rulemaking 01-12-009. The March 11, 2002 Scoping Memo, as amended, in this

Rulemaking confirmed the categorization of this proceeding as quasi-legislative and determined that hearings were not necessary. The Scoping Memo rejected the need for hearings reasoning that "[r]eadjusting a utility's specific rate of return is not within the scope of this industry wide proceeding. The appropriate rate of return is an issue for the utilities' general rate cases. Furthermore, the question of how various risks affect a utility's rate of return involves an inquiry into all relevant circumstances, not just one specific factor. Again, the appropriate forum for such an inquiry is a utility's general rate case, or other appropriate proceeding the Commission may designate in the future." (March 11, 2002 Scoping Memo, pp. 5-6.)

According to Section 1701.1(a), our decision as to the nature of the proceeding shall be subject to a request for rehearing within 10 days of the date of that decision. Neither applicant objected to the categorization of this proceeding as quasi-legislative by filing for a rehearing, despite the fact that both had the opportunity to do so knowing that evidentiary hearings are not mandated in a quasi-legislative proceeding.

Thus, neither CWA nor SCWC has established legal error in its claim that we should have held evidentiary hearings. It was appropriate for us to revise our balancing account procedures by way of rulemaking. All affected parties had notice and ample opportunity to participate in the proceeding. Class A utilities were made respondents to the OIR. Applicants not only filed comments, but participated in oral argument on September 20, 2002, on all issues in this rulemaking. (D.03-06-072, pp. 4, 6.) Based on the above, it is evident that applicants were afforded procedural due process.

B. The Decision Does Not Result In An Unconstitutional Taking Of Property Without Due Process Of Law

Both CWA and SCWC assert that the revised procedures for recovery of balancing accounts result in an unconstitutional taking, or deprivation of property, without due process of law. (CWA Rhg. App., pp. 10-11; SCWC Rhg. App., p. 7.) Again, applicants' real challenge here appears to be to the Commission's ability to revise our procedures.

CWA argues that a public utility is entitled to recover the costs it reasonably and prudently incurs in providing utility service, and that those recoverable costs are the utility's property. Moreover, CWA asserts that the decision confirms this by acknowledging that, prior to November 29, 2001, utilities could legally book balancing account costs to a "deferred debit account" and, for accounting purposes, claim them as an asset on their balance sheets (Id. at 11, citing D.03-06-072, p.2, fn. 1). Therefore, CWA argues that the costs accrued in balancing accounts – just like any item that can be claimed as an asset on a balance sheet - are the property of a utility. CWA further argues that the decision deprives a utility of that property in circumstances where the utility is deemed to be earning above its authorized rate of return. (CWA Rhg. App., p. 11.)

CWA fails to acknowledge that the reason utilities could legally book balancing account costs to a deferred debit account and claim such costs as an asset on a balance sheet was because our balancing account procedures allowed them to do so. Pursuant to our authority to regulate water utilities,[4] we may revise these procedures by requiring utilities that are over earning their authorized rate of return to use such over earnings as a measure by which to reduce offset expenses before being able to recover such expenses from the balancing account In the proper exercise of our authority over Class A Water Utilities, we have done so in D.03-06-072. Pursuant to this decision, we require a utility to use its over earnings as a measure by which the utility reduces offset expenses before being able to recover such expenses from the balancing account. When a utility is over earning such expenses can no longer be booked as an asset for accounting purposes and cannot be carried on the utility's books.

SCWC argues that "[b]ecause the costs booked into a supply cost balancing account are actually incurred expenses, a utility has a vested property right in the recovery of those expenses." (SCWC Rhg. App., p.7.) SCWC points out that public utilities have a legal right to recover all reasonable expenses incurred in the provision of utility service. (Id, citing *SoCal Edison*, supra, at 818.) However, SCWC fails to

[4] The Commission regulates water utilities pursuant to Article XII of the California Constitution, and Sections 701 and 2701 et seq.

acknowledge that if a utility is over earning, it already has a revenue stream from which to recover not only all reasonable expenses but also all significant unforeseen expenses incurred in the provision of public utility service. In other words, the utility does not need to recover these expenses from the balancing account.

Moreover, a review of United States Supreme Court cases regarding when a ratemaking order results in an unconstitutional taking indicates that it is the effect of the rate order, not the methodology employed in its implementation, that determines whether a taking has occurred. "Rates which are not sufficient to yield a sufficient return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment." (*Bluefield Water Works and Improvement Company v. Public Utilities Commission of the State of West Virginia Et Al. (1923)* 262 U.S. 679, 690.) "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." (*Federal Power Commission et al. v. Natural Gas Pipeline Co. (1942)* 315 U.S. 575, 586.) "[I]t is not theory but the impact of the rate order that counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed may contain infirmities is not then important." (*FPC v. Hope Natural Gas Company (1944)* 320 U.S. 591, 602.) "The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect." (*Duquesne Light Co. v. Barasch (1989)* 488 U.S. 299, 314.)

In this case, revising such procedures does not amount to a rate order, and certainly doesn't rise to the level of an unconstitutional taking since the revised procedures have neither a confiscatory nor unreasonable effect on a utility's rates. To protect the interests of ratepayers, we have revised the procedures for recovery of offset expenses from balancing accounts. Such action does not result in a violation of either substantive or procedural due process, nor does it in any way result in an unconstitutional taking. Moreover, both CWA and SCWC fail to acknowledge that there is no taking of property if a party has no inherent right to the property in question. Since state law only affords utilities an opportunity to earn a fair rate of return (*Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, *supra*, 262 U.S. 679, 692-693), neither CWA nor SCWC has a right to recovery of any offset expenses in a balancing account. Thus, no unconstitutional taking arises from our decision to adjust the procedures for recovery of offset expenses in balancing accounts when utilities are over earning.

IV. THE DECISION DOES NOT VIOLATE SECTION 792.5 OF THE PUBLIC UTILITIES CODE

In 1976, the Legislature enacted Section 792.5, which authorized expense offsets and required that utilities, upon receiving authorization to pass through the expense costs, maintain a reserve account reflecting the difference between actual costs incurred by the utility and the revenue collected through the offset rate increase. CWA alleges that by "requiring a water utility that is over earning to reduce the amount of any undercollections [offset expenses] by the amount of over earning, to remove the amount of the over earning from the balancing account, and to amortize the removed amount below the line, the Commission is changing the statutory rules governing balancing accounts in a way not authorized by law." (CWA Rhg. App., p. 15.) SCWC alleges that D.03-06-072 violates Section 792.5 by requiring a reserve account that no longer reflects the balance between supply costs and revenues. (SCWC Rhg. App., p. 5.) Moreover, SCWC alleges that the calculation of the balancing account as provided in Appendix A of the decision contravenes the plain language of Section 792.5. (Id. at 6.)

Applicants' assertions are inaccurate and without merit. Section 792.5 does not prescribe a method by which we shall adjust or not adjust the balancing account. The methods used, such as the revised procedures, are at our discretion. Section 792.5 confirms this by authorizing us to take into account by appropriate adjustment or other action any positive or negative balance remaining in the balancing account.

CWA states that Section 792.5 governs balancing accounts for both electric and water utilities without distinction between the two industries. (CWA Rhg. App., p. 17.) CWA asserts that, unlike balancing accounts for electric utilities, those for water utilities are now subject to an earnings test and that "[t]he Commission has not explained why recovery of undercollections [offset expenses] in water utility balancing accounts should be conditioned on whether or not a water utility is over earning, when no such condition applies to electric utilities." (Id. at 18.)

CWA fails to acknowledge that historically there have been differences between the two types of balancing accounts, and that we are under no obligation to use the same procedures for water utility balancing accounts as we use for electric utility balancing accounts. Balancing accounts for water utilities record only the incremental change in cost increases incurred and revenues received since the utility's last GRC or last offset rate increase. Moreover, the application of an earnings test to balancing accounts is not new. We first established rules for expense offsets for water utilities in 1977, and those rules required that a rate of return, means test be applied to determine a utility's eligibility for the offset program. (Reso. W-4294, p 8**.)**

Balancing accounts for electric utilities differ by incorporating all rates established to provide revenue to utilities for fuel costs, offset rate increases, as well as rates established in the GRC. All of the revenue received for the fuel expenses are then compared to all bills for fuel incurred to determine the over or under collection in the account. (See the Energy Resource Recovery Adjustment (ERRA), D.02-10-062, formerly ECAC.) Before recovery is allowed, electric utility balancing accounts must undergo a reasonableness review, which is a lengthy and contentious process. If some expenses are found to be imprudent, those expenses are disallowed for recovery.

Based on the above, it is evident that the revised procedures for recovery of balancing accounts do not violate Section 792.5.

V. THE EXCLUSION OF "EXTRAORDINARY ITEMS" OF REVENUE AND EXPENSES FROM THE CALCULATION OF OVER EARNINGS IS NEITHER UNLAWFUL NOR UNCONSTITUTIONAL

D.03-06-072 requires water utilities, when determining over earnings, to identify any extraordinary sources of revenues or expenses that are not typically experienced every year and to exclude them, unless they were included as reasonable forecasts in the utility's last GRC. (D.03-06-072, Appendix A, No. 3.) CWA alleges that the exclusion of extraordinary items from the determination of whether a utility is over earning is not supported by any evidence, and is arbitrary and capricious in violation of substantive due process. CWA also alleges that the decision is vague and ambiguous in its failure to define an extraordinary expense or revenue. (CWA Rhg. App., p. 19 – 21.)

Once again, these objections are inaccurate and without merit. Extraordinary expenses are by their very nature unusual and not readily foreseeable. Further, extraordinary expenses and income have never been treated as part of the regular earnings calculations of water utilities by our procedures, nor should they be. Such expenses are inherently unpredictable and not part of the "business as usual" operations of the utility. Thus, they should continue to be treated via Advice Letters and Memorandum Accounts and not considered part of the earnings or expenses used for calculating regular utility earnings. Using such expenses and income for purposes of calculating utility earnings would distort rather than correct the comparison of actual expenses to actual earnings because of the "extraordinary" nature of such expenses and income. Providing the Advice Letter and Memorandum Account process ensures that we will consider any extraordinary cost or revenue item. Thus, the claim that the exclusion of extraordinary items is arbitrary and capricious and violates substantive due process lacks merit.

VI. APPENDIX B OF D.03-06-072 IS REVISED TO CLARIFY NEW PROCEDURES FOR RECOVERY OF BALANCING ACCOUNTS

Appendix A of D.03-06-072 sets forth the new procedures water utilities are required to follow for processing of balancing accounts existing on or after November 29, 2001. Appendix B provides an example of the revised procedures. SCWC alleges that the example in Appendix B "makes clear, the new revised procedures are intended not only to deny recovery of balancing account costs, but also to refund utility earnings in excess of adopted levels." (SCWC Rhg. App., p. 9.)

Both of these assertions are inaccurate. The revised procedures neither deny recovery of offset expenses, nor require a refund of over earnings. The revised procedures simply require a utility that is over earning to use such over earnings as a measure by which to reduce offset expenses before being able to recover from the balancing account. If the over earnings equal or exceed the offset expenses, then any offset revenues – not over earnings - that were collected from ratepayers shall be returned to them. Thus, the revised procedures ensure that balancing accounts are being used for their intended purpose – to protect utilities from significant unforeseen expenses - while ensuring that ratepayers don't fund a windfall to utilities. However, we agree that Appendix B needs clarification. Therefore, we delete Appendix B and replace it with Appendix B1 contained in Attachment A of this order. The example in Appendix B1 deals with the case where a utility is over earning, but the over earnings are less than the offset expenses in the balancing account.

VII. CONCLUSION

We modify D.03-06-072 pursuant to the discussion above in order to clarify the intent of the new revised procedures. The rehearing applicants have failed to demonstrate any factual or legal error in D.03-06-072, as modified, and rehearing is denied.

THEREFORE, IT IS ORDERED THAT:

1. On page 2, delete the first full paragraph, and insert: In this decision, we revise the existing procedures for recovery of balancing accounts existing on or after November 29, 2001, as follows:

(1) If a utility is either within or outside of its rate case cycle and is not over earning, the utility shall recover from the balancing account subject to reasonableness review.

(2) If a utility is either within or outside of its rate case cycle and is over earning, the over earnings will be used as a measure by which recovery of offset expenses in the balancing account will be reduced. For example, if the amount of the over earning is equal to or exceeds the amount of offset expenses to be recovered in the balancing account, those expenses shall be reduced to zero. Any offset expenses collected in the balancing account would be amortized below the line and any offset revenues collected in the balancing account would be returned to ratepayers.

(3) If a utility is within or outside of its rate case cycle and is over earning, but the over earnings are not equal to or greater than the offset expenses accrued in the balancing account, the offset expenses in the balancing account will be reduced by the amount of the over earnings. If there are offset revenues in the balancing account, then these shall also be used to reduce the remaining offset expenses accrued in the balancing account to zero. After the offset expenses in the balancing account are reduced to zero, if any offset revenues remain in the balancing account, such revenues shall be returned to ratepayers. If, conversely, after adjusting offset expenses in the balancing account by the amount of over earnings and offset revenues, offset expenses still remain in the balancing account, such expenses shall be amortized and recovered through a surcharge request in an Advice Letter or a General Rate Case.

2. On page 6, in line 4 from the top of the page, delete the word “state” and insert: stale

3. On page 15, in the first full paragraph, in line 7 after the word “is” insert: over

4. On page 15, in the first full paragraph, in line 8, delete "above its authorized rate of return, recovery of" and insert: , such over earnings shall be used as a measure by which recovery of offset expenses from

5. On page 15, in the first full paragraph, in line 9, delete "by the amount of over earning"

6. On page 17, delete the following phrase from the first full paragraph: "The proposal is not unfairly "one-sided" as claimed." and insert:

It is incorrect for the utilities to argue that the revised procedures cap their recovery of the balancing account so that a utility may achieve, but not exceed, its authorized rate of return. The revised procedures simply require a utility that is over earning to use such over earnings as a measure by which to reduce offset expenses before allowing the utility to recover such expenses from the balancing account. Recovery from a balancing account was never intended to enhance a utility's earnings.

7. On page 17, in the first full paragraph, in line 7, before the word "balancing" insert: offset expenses from the

8. On page 17, in the first full paragraph, in lines 7 and 8, delete the words "amounts in excess of its authorized rate of return"

9. On page 19, in the fourth full paragraph, delete lines 1 to 3, inclusive, in line 4, delete the words "and (3) districts that are outside of their rate case cycles." and insert: We address the following scenarios: (1) districts that are either within or outside of their rate case cycle and are not over earning; and (2) districts that are either within or outside of their rate case cycle and are over earning on an actual (recorded earnings) basis.

10. On page 21, in the fourth full paragraph, in line 1, delete the word "within" and insert: either within or outside of

11. On page 22, delete paragraphs 1 and 2, and insert: If a utility is either within or outside of its rate case cycle and is over earning, the over earnings will be used as a measure by which recovery of offset expenses in the balancing account will be reduced. For example, if the amount of the over earning is equal to or exceeds the

amount of offset expenses to be recovered in the balancing account, those expenses shall be reduced to zero. Any offset expenses collected in the balancing account would be amortized below the line and any offset revenues collected in the balancing account would be returned to ratepayers.

12. On page 22, in the third paragraph, in line 1, before the word "Although" insert: The recorded earnings means test shall be used to evaluate earnings for revenue received for all years.

13. On page 25, in paragraph 1, in line 3, delete "within" and insert: either within or outside of

14. On page 25, in paragraph 1, line 5, delete "the utility's recovery of expenses", delete lines 6 to 11, inclusive, and insert: the over earnings will be used as a measure by which recovery of offset expenses in the balancing account will be reduced. For example, if the amount of the over earning is equal to or exceeds the amount of offset expenses to be recovered in the balancing account, those expenses shall be reduced to zero. Any offset expenses collected in the balancing account would be amortized below the line and any offset revenues collected in the balancing account would be returned to ratepayers.

15. On page 27, in paragraph 1, line 5, delete "B" and insert: B1.

16. Appendix B is deleted and replaced with Appendix B1, contained in Attachment A of this Order.

17. Rehearing of D.03-06-072, as modified, is denied.

This order is effective today.

Dated March 16, 2004 at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
Commissioners

I dissent.

/s/ SUSAN P. KENNEDY
Commissioner

Commissioner Susan P. Kennedy, dissenting:

In D.03-06-072, the Commission required that all balancing and memorandum accounts be reimbursed to companies only if the utility passed a "pro-forma" earnings test. We should set aside submission and reopen the record because there are already substantial indications that D.03-06-072 is producing unanticipated outcomes, adverse to water utilities and adverse to the long-term interest of ratepayers.

D.03-06-072 argued that the balancing account procedures became problematic because they had the effect of enhancing a utility's earnings above a Commission authorized rate of return.

In attempting to understand this, I pored over years of earnings by water utilities, and not only did I find this to be not true, I found that the opposite becomes true when you apply an earnings test in this manner.

First, the Water Division's district-by-district charts supporting the allegations of over-earnings are flat out wrong. For some reason whoever prepared these reports chose to ignore real additions to rate base. Thus, the Water Division calculated earnings using **real revenues but failed to look at equally real investments.** The Water Division's numbers have two effects: first, by failing to use real investments, its apples to oranges comparison systematically overstates earnings – often in excess of 100 basis points; second, by using the percentage of over- and under-earnings, the Water Division inflates our perceptions of what is actually happening.

For example, the very first number in the Water Division's chart says that SoCal Water's Arden Cordova District in 1996 had revenues 36% *under* their authorized ROR. This would translate into earnings of

5.9%, 36% below the adopted 9.32%. In fact, the documents filed with the Commission show that the recorded ROR was 5.6% that year – because, of course, you should recognize real investments in ratebase.

Similarly, the 1996 chart of Water Division for SoCalWater shows total company earnings for all districts as 14.5% above authorized. Since the adopted ROR was 9.5%, this suggests that the ROR in 1996 was 10.88%. When, however, we use recorded earnings and recorded ratebase, we find that the ROR was actually 8.79%. Thus, the Water Division's methodology overstates earnings in this case by 209 basis points.

This dynamic is repeated in every year and for every company using Water Division's methodology.

Frankly, if the Commission were as far off in setting rates for these districts as Water Division thinks we were, then every single one of us on this Commission and on staff should be mandated to go to back to rate school. We should compare real earnings with real investments, not real earnings to forecast investments.

But we haven't been off in setting rates. In fact, taking into consideration weather conditions that so uniquely impact the water industry utilities – we've been right on the money. Years where they ***over***-earn balance out years where they ***under***-earn.

And I have to say, I am extremely disturbed that information that is so distorting was given to this Commission – not once, but twice. This Water Division table, which applies the methodology adopted in D.03-06-072 to water districts over many years, totally distorts the earnings of these companies, making it look as if they are systematically over-earning. There is no excuse for this.

D.03-06-072 seriously undermines the regulatory balance that is so critically needed in the water industry today. With the earnings test applied to memorandum and balancing accounts, we *guarantee* that they will ***never*** over-earn. But we don't guarantee that they will never ***under***-earn.

So this policy will, without question, impact their decisions on investment and expenditures in a negative way. Instead of making decisions based on water quality and infrastructure needs – they will have to play the "earnings game". They will have to anticipate and adjust their expenditures – painting water tanks when necessary, and avoiding testing for perchlorate contamination when possible – in order to make sure they come in right at their authorized ROR. Because they know they will never recover the under-earnings <u>any other way</u>, and they know that over-earnings will be taken away.

Look at what the rating agencies are doing to these companies. Just last week, CalWater Service had its debt ratings downgraded. SoCal Water remains on credit watch. In both cases, regulatory uncertainty with regard to rate cases and recovery of capital expenditures is cited – partly because statutory requirements for water quality are pushing the need for capital investments higher. When coupled with regulatory uncertainty of the type we find here, it creates significant financial risk.

If these companies were systematically over-earning or making money hand over fist, do you think they'd be on credit watch? The systematic over-earning is simply a fiction of the methodology we have adopted. Even if this methodology is sufficient to mystify the Commission, it is not sufficient to deceive bond-rating agencies and market analysts.

If the Commission would simply take the time to look at the evidence, you will see that many of these companies are barely earning ***any*** ROR in some years, and the earnings test as it is applied in D.03-06-072 systematically overstates earnings and the resulting disallowances produce systematic under-earnings.

A second rationale for the earnings test offered by D.03-06-072 was that at times some utilities would fail to file a GRC application every three years, and over earnings could persist. This implies that these companies stay out on purpose because they are over-earning.

First of all, while that may be true in some isolated cases with small companies – there is no evidence of that being the case generally. In fact, what I found is that the reason some don't come in is because it would cost them more money to file the rate case than they would receive in a rate increase.

But this is a moot point. New legislation now requires each class A water company to have a GRC every three years. Thus, a statute corrects this problem, and the earnings test is <u>not needed</u>.

The Commission should set aside submission and reopen this record to examine these issues in more detail. In my view, the earnings test was a policy innovation that was oversold – it is unclear that the problem it purports to correct actually exists; it fails to work as advertised; it undercuts other policies, such as those that encourage water quality testing or litigation to recover costs from polluters; and it undermines the ability of our utilities to invest in California's infrastructure.

There may be no legal error in D.03-06-072, but there are clearly problems in that decision.

I voted for D.03-06-072, and I'm not afraid to admit that I made a mistake. We should return this matter to Commissioner Brown for further record development and to correct these failing policies.

For all these reasons, I must respectfully dissent.

/s/ SUSAN P. KENNEDY

Susan P. Kennedy

March 16, 2004